BUSINESS & LABOR
EXHIBIT NO. 4
DATE 3-3-09
BILL NO. HB 160

TESTIMONY FROM AMERICAN INSURANCE ASSOCIATION
AND SURETY ASSOCIATION OF AMERICA
Re: Montana State Auditor's Proposed Amendments to HB 160
Senate Business, Labor, and Economic Affairs Committee
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The bill currently proposes to amend 33-28-102, MCA, to permit a captive insurance company to apply to the Commissioner for a license to write surety insurance. By law, the captive could write surety insurance only for its parent and affiliated companies, if a pure captive, or for its members or group of members, if an association captive. This means that an innocent third party relying on the existence of a bond would find that if the parent or affiliates became bankrupt or otherwise defaulted, it would have no independent entity to look to for payment of claims.

An insurance policy is a two-party contract that protects the insured by shifting the primary risk of a fortuitous loss to the insurer in return for payment of a premium. The underwriting of insurance policies is largely to determine an appropriate premium for the risk assumed. If a company or group of companies form a captive to provide insurance policies, they are the only insureds and they run the risk that the captive will not have adequate capital to meet its obligations.

A surety bond is a three-party contract under which the surety agrees to answer for the debt or default of the principal. The bond does not protect the principal, the party whose performance is guaranteed, even though the principal selects the surety and pays the cost of the bond. The bond is provided because the Government requires it to protect the public or those members of the public who deal with the principal or because the private obligee requires it to protect itself. For example, the law requires a payment bond on public construction projects to protect subcontractors and suppliers who work on the project. On a private construction project, the owner requires a payment bond to assure that subcontractors and suppliers are paid and to protect the owner's property from mechanics liens.

The surety bond does not protect the bond principal. The company or companies that formed the captive run none of the risk that surety bonds written by the captive are inadequate. The third parties who relied on the bonds, and who will not necessarily know who the surety is until there is a default, run 100% of the risk that the surety will not be able to meet the obligations of the bond. Unlike an insurance policy, the entity that selects the surety and pays the premium is not protected by the bond.

One of the reasons that the Government or private party require a bond is for the surety to underwrite the prospective principal and exclude anyone likely to default. If the captive insurer provides the bond, it presumably is not going to underwrite its parent or affiliate. It likely will provide the bond upon request and payment of the premium, which will both make defaults much more likely and obviate one of the reasons for the bond. Essentially, the parent or affiliate is bonding its own obligations.

Losses covered by surety bonds are not fortuitous. For example, if a construction contractor becomes bankrupt, there are likely to be claims on all of its outstanding bonds. A captive cannot spread the risk of contractor bankruptcy over a large number of principals because it can write only for its parent or group. If the parent or a large group member defaults, it is likely to bankrupt the captive.

One of the attributes of personal lines and workers compensation insurance is that they protect the public (auto liability, for example) or particular categories of the public such as the insured's employees. Section 33-28-102 provides that captives cannot write personal lines or workers compensation insurance. The same reasoning applies to surety bonds. The bonds are required to protect innocent third parties who depend on the bonds. A captive will not underwrite the principal and will likely be unable to pay claims if the parent defaults.